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Central Intelligence Agency

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Washington, D.C. 20505

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18 July 1985

MEMORANDUM FOR: Ambassador Jack Matlock
Senior Director, European and
Soviet Affairs
National Security Council

SUBJECT : Briefing Papers

Jack:

I am forwarding two additional papers under the heading of
the "Soviet Union from the Inside"--[Redacted] essay on
the "Soviet Economy" and [Redacted] contribution on the
"Role of Foreign Trade."

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[Redacted]
Melvin A. Goodman

Attachments:

1. "The Soviet Economy in Perspective"
2. "The Role of Foreign Trade in The Economy"

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The Soviet Economy in Perspective

The Soviet economy, the second largest in the world, has grown since 1950 from about one-third to more than one-half the size of the US economy. The basic tenets of Soviet growth strategy have been:

- a high rate of investment in heavy industry, fuels and power, and construction; a lower rate in consumer goods and agriculture;
- emphasis on modern, capital-intensive technology in the favored sectors; use of old-fashioned, labor-intensive methods in the low priority sectors;
- large expenditures on education and science to raise the technical skills of the population;
- acquisition of advanced Western technology and equipment in exchange for raw materials.

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Making and Implementing Economic Policy

This is a "command economy." Basic economic decisions are made by central administrative fiat rather than in the market place:

- The Politburo of the Communist Party makes the major economic decisions.
- Given these guidelines, a huge bureaucracy--headed by the Council of Ministers--sets specific output goals,

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allocates manpower and materials, fixes wages and prices, and regulates incentives.

- Lower down, state-owned industrial facilities and collective farms translate the economic plans into action.

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The Politburo--the highest executive arm of the Central Committee of the Communist Party--acts much like the board of directors of an enormous conglomerate. As chairman of the board, General Secretary Gorbachev presides over weekly Politburo meetings where decisions on general economic priorities are reached. It is the Politburo that decides on the division of resources between military and civilian use and the distribution of investment between industry and agriculture.

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The Council of Ministers--the government's highest executive body--can be likened to a senior management team of the conglomerate. The Chairman of the Council, Nikolay Tikhonov, has final responsibility for determining the output of all major commodities, distributing resources, and ensuring that plans are fulfilled. The organization under the Council includes the State Planning Committee (Gosplan), more than 50 functional economic ministries (such as ferrous metallurgy, foreign trade, and agriculture), and a host of state committees and main administrations concerned with finance, prices, supply, and the like. The State Planning Committee is now working on the Twelfth Five-Year Plan for 1986-90.

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Strengths

The Soviet economy has great crude economic strength, based on a wealth of natural resources, a labor force half again as large as that of the United States, a large and growing stock of industrial facilities, and an unchallenged leadership dedicated to continual expansion of industrial and military might. Growth has been maintained by the brute force method of allocating about 1/3 of national output to investment and by extracting as large a work force as possible out of the populace. This growth formula has enabled the Soviets to amass an ever increasing arsenal of sophisticated weapons, to continually expand their industrial base, and to provide some increase in living standards each year.

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Weaknesses

A number of persistent problems that have plagued the Soviet system for years have become particularly troublesome since the mid-1970s.

- Low productivity and the declining efficiency of investment. Despite a growing volume of investment per worker, labor productivity in Soviet industry is only about half the US level. This is particularly serious since annual additions of men and equipment are becoming smaller, and productivity gains must be the future source of growth. An added difficulty is the gradual exhaustion of easily accessible natural resources and the rising cost of exploiting new resources, many located in remote and frozen areas of Siberia.

- Technology gap. Although the latest technology is employed in some areas--particularly in the defense and space industries--technology in the civilian economy generally lags far behind that of the West. The Soviet system is particularly ineffective in moving new ideas and products from the research and development stage into full assembly-line production. Moreover, Western equipment frequently is not as productive in a Soviet setting as it is on native ground. At the same time that the USSR is struggling to catch up, the United States, Western Europe, and Japan are forging ahead with still newer technology.
- Rising consumer expectations. Though well-fed and clothed compared with past generations, Soviet consumers are increasingly aware of the disparity between Soviet and Western living standards. Consumer grievances are especially acute as to housing, long queues, and the poor quality of durables and other consumer goods and services.
- Inefficient agriculture. Nearly one-fifth of the labor force is still employed on the farm; equipment is badly operated and maintained; and the cost of producing grain and meat is far above world market prices.

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Most of these problems are rooted in the Soviet system of planning and management, which is too centralized and clumsy for effectively managing the increasingly complex economy. Central

Planning, for example, becomes more difficult as the number of links between producers, consumers, and suppliers multiplies.

The Soviet incentive system is especially ill-equipped to deal with today's problems. Although it was effective in maximizing physical output in the 1950s and 1960s when resources and raw materials were cheap and readily available, in recent years it has led to industrial bottlenecks, encouraged waste and mismanagement of resources, contributed to irrational investment decisions, retarded scientific-technological innovation, and stimulated widespread corruption and illegal economic activity.

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As a result of these weaknesses, Mikhail Gorbachev inherited a decade-old economic slowdown punctuated by harvest failures, industrial bottlenecks, labor and energy shortages, low productivity, and declining efficiency of investment. Part of the problem has been the result of external factors:

- Harsh weather conditions that have depressed farm output.
- Declining increments to the working age population that have led to labor shortages.
- Rising costs and increasing difficulty of extracting and transporting energy resources and other raw materials, which have exacerbated the squeeze on labor and capital resources and intensified the impact of bottlenecks already present in key sectors of the economy.

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But the key source of the USSR's economic slowdown--as Gorbachev himself has implied--is systemic: The growing inadequacy of existing methods of planning and management. [REDACTED]

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Economic Prospects Under Gorbachev

Since coming to power in March 1985, Gorbachev has moved forcefully to place his personal stamp on economic policy, telling managers that they must change the way they do business or "get out of the way." His frankness illustrates the strong emphasis he is placing on the need for competent personnel and for tougher standards of performance evaluation. He seems to have a clear understanding of the economy's problems and is determined to deal with them. Gorbachev has described the acceleration of economic growth as his major domestic goal and laid out a growth strategy that includes increasing the pace of scientific and technological progress, restructuring investment, reorganizing management and planning, and tightening economic discipline. [REDACTED]

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The key element in implementing this policy is to be the "re-equipping" of the economy with high-quality, technologically-up-to-date machinery. This, he says, will require sharp increases in machinery production and a larger share of investment in machinery producing facilities. The other significant known components of his plans for dealing with the economy are essentially continuations of policies introduced in recent years, but not effectively implemented. These include vigorous application of Andropov's discipline campaign which waned under Chernenko, linking wages more closely to

productivity, implementing Brezhnev's 1982 Food Program of which he was primary architect, providing more operational autonomy for enterprise managers, and sharply curtailing the powers of the ministries. [REDACTED]

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- Gorbachev has indicated that a reorganization of the economic bureaucracy will be a major part of his strategy. His June speech in Dnepropetrovsk suggested that plans for such a reorganization have now reached an advanced stage and that they include the creation of superministerial bodies, starting with agro-industrial and machine-building sectors. His speeches also suggest that these super-ministries will be restricted to "strategic" planning and leave operational control of enterprises in the hands of the managers on the scene. [REDACTED]

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Gorbachev's program could result in improved economic performance if vigorously pushed. Priority development of the food industry, for instance, coupled with greater attention to transportation and storage facilities could considerably reduce the present enormous waste and spoilage of agricultural produce. Moreover, the discipline campaign, which was evidently a significant factor in the economic upswing during Andropov's tenure, could again have a favorable impact on economic performance. Gorbachev is gambling that an attack on corruption and inefficiency, not radical reform, will turn the economy around. Although his approach is risky--previous attempts to redirect investment resources and other economic initiatives generally have been frustrated by entrenched bureaucratic interests--his prospects for success should not be

underestimated. [REDACTED]

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How much economic improvement occurs and how long it lasts will depend largely on whether Gorbachev can deal successfully with the economy's systemic problems. He has not, for example, squarely addressed such problems as the arbitrary nature of Soviet prices, which prevent planners from making economically rational decisions, or the lack of sufficient consumer input into decisions on what to produce. Nor has he explained how, in a period of likely resource stringency, with investment to grow at an accelerated rate and defense likely to have a strong claim on resources, the consumer's needs can also be addressed. [REDACTED]

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There have been hints, however, in Gorbachev's past and recent speeches, and in the statements of some knowledgeable Soviet officials, that the General Secretary may eventually tackle some of these problems. In his Lenin Day address in April 1983, for example, Gorbachev stressed the importance of greater reliance on prices as an economic lever. He returned to this theme in his June 1985 address to the S&T conference, calling for a more decisive shift from administration to economic methods of regulating the economy. In the same address he also called for an end to "the domination of the consumer by the producer." [REDACTED]

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[REDACTED]

Gorbachev may well have decided to refrain from translating such vague expressions of support for controversial measures into specific proposals until he has fully formulated his plans and/or consolidated his political strength. A Soviet political commentator privately characterized Gorbachev's current approach

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as one of first adopting uncontroversial economic measures while simultaneously working on a long-range and more far-reaching program. Alternatively, Gorbachev may have refrained from bolder measures because he hopes that the steps he has already proposed will be sufficient to remedy the economy's ills. Indeed, he has made clear that he remains committed to the basic system of central planning. In either event, the political momentum he already enjoys augurs well for his future ability to take bolder steps, and the ambitious nature of the goals he has set increases the chances that he will have to do so.

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USSR: The Role of Foreign Trade in the Economy

Foreign trade plays an important, albeit not critical, role in Soviet economic development. Although the Soviet economy is largely self-sufficient--purchases from abroad account for only about 10 percent of GNP--imports have helped Moscow improve consumption, boost productivity, remove industrial bottlenecks, and modernize weapon systems. [REDACTED]

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East-Versus West as a Source of Imports

The USSR has traditionally favored its communist allies in its foreign trade.

- About 65 percent of the USSR's machinery and equipment imports come from its Communist allies, mostly the East European countries.
- These imports represent nearly half of all Soviet purchases from Communist countries. (See Figure 1)

Although East European machinery and equipment is often of lower quality than Western equipment, it is equal to or better than Soviet produced goods in many instances. The USSR also looks to Communist countries for manufactured consumer goods to supplement its own production. More than half of such imports--primarily clothing and furniture--are purchased in Eastern Europe. [REDACTED]

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While relying on Eastern Europe for much of its machinery and equipment needs, imports of Western technology and equipment have been essential to expand selected Soviet industries (e.g.

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FIGURE 1

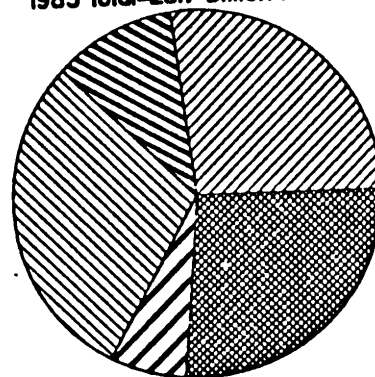
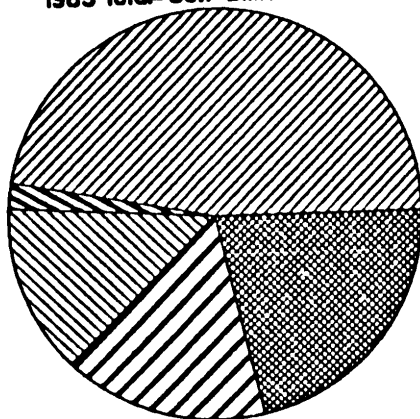
Soviet Imports by Comodity, 1983

Communist Countries

Non-Communist Countries

1983 Total=33.7 Billion Rubles

1983 Total=25.7 Billion Rubles



▨ Machinery
▩ Ferrous Metals
▧ Agricultural
▦ Consumer Goods
■ Other

chemicals and automobiles), despite difficulties in assimilation.

- Imported chemical equipment in the 1970s was largely responsible for a doubling in the output of ammonia, nitrogen fertilizer, and plastics during this period.
- Construction of the Kama river truck plant, which is based almost exclusively on Western equipment and technology, has resulted in a roughly 100 percent increase in Soviet heavy truck output over the past decade. [REDACTED]

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Imports from the West also have played a key role in supporting the energy sector.

- The rapid construction of the Siberia-to-Western Europe gas pipeline would not have been possible without purchases of Western turbines, compressors, and pipe.
- Difficiencies in Soviet drilling, pumping, and exploration have prompted Moscow to purchase almost \$20 billion in oil and gas equipment since 1975.

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Imports of grain and other agricultural products have been the largest component of the USSR's western trade. A series of mediocre harvests during 1981-84 has pushed agricultural imports to record levels--with average annual purchases of some \$10 billion during this period. Because of the limited ability of Communist countries to expand grain production, Moscow has had to rely almost entirely on Western countries to fill the gap between

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domestic output and requirements. [REDACTED]

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Finally, in addition to contributing to specific industrial sectors and overall consumer well-being, acquisition of goods and technology from the West has enhanced Soviet military programs.

- Access to specific technologies has permitted improvements in a number of weapon and military support systems.
- Gains from trade, in general, have improved the efficiency of the economy and thereby reduced the burden of defense. [REDACTED]

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Composition of Soviet Exports

In contrast to its imports, Soviet exports are composed mostly of raw materials, particularly energy. This concentration of trade has become particularly prominent since the mid-1970s as a result of rapidly rising fuel prices. By 1983, 70 percent of total Soviet exports to non-Communist countries and 50 percent of exports to Communist countries consisted of fuel shipments. (See Figure 2). Although arms exports to non-Communist countries are not specified in Soviet trade statistics, we estimate that this trade accounted for some 15 percent of total Soviet exports in 1983. Only 5 percent of Soviet exports are agricultural goods.

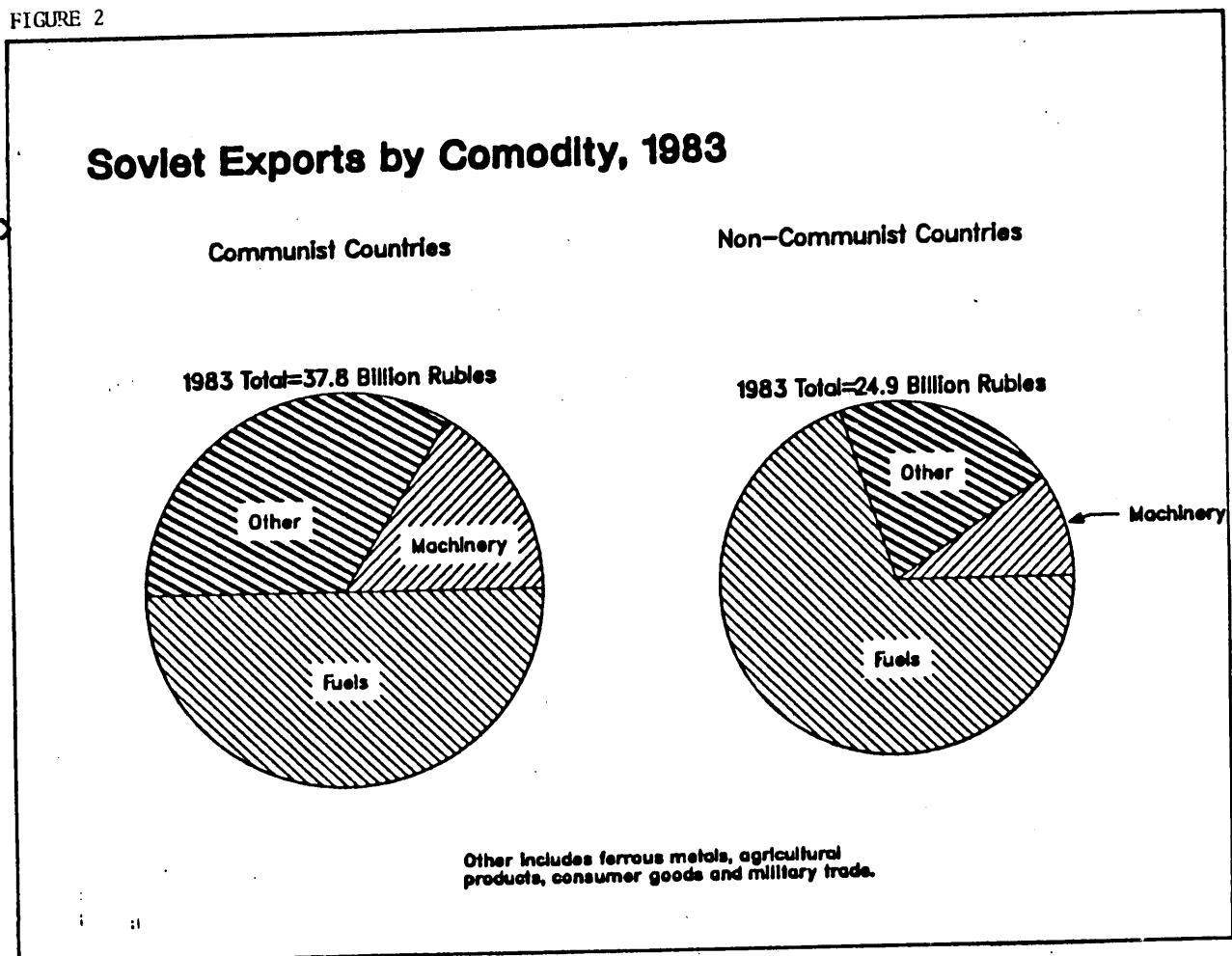
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Soviet Trade With the Third World

Unlike Soviet trade with the developed West, which is essentially an exchange of Soviet industrial raw materials for technology and agricultural products, Soviet-LDC trade consists of an exchange of Soviet manufactures--mainly military supplies--

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FIGURE 2



for industrial and agricultural raw materials. The LDCs represent Moscow's only major outlet outside the Bloc for exports of civilian and military manufactures. []

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Soviet military exports are the largest and most dynamic element in the trade. Such exports totaled over \$9 billion in 1982 and 1983, an amount equal to almost 70 percent of total Soviet exports to the LDCs. The military sales program offers Moscow substantial benefits:

- It is a major tool for establishing Soviet presence and expanding influence in LDCs.
- It provides Moscow with one of the few export opportunities in which Soviet-manufactured goods are somewhat competitive in price and quality with Western products.
- After credits and payments reschedulings are netted out, it generates perhaps \$5-6 billion per year in hard currency revenues or their equivalent. []

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US-Soviet Trade

With the exception of agricultural imports, Soviet trade with the US has been relatively small. The US did participate in the expansion in commercial relations that accompanied East-West detente in the 1970s.

- US exports to the USSR totaled only \$100 million in 1970, or less than 5 percent of Soviet hard currency imports.

- By 1979, US sales totaled \$3.8 billion, nearly 20 percent of hard currency purchases. (See Figure 3)

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Following the sanctions imposed in the wake of Soviet intervention in Afghanistan and imposition of martial law in Poland, US-Soviet trade dwindled. US machinery and equipment sales suffered the most, plunging from a peak share of 20 percent of Soviet orders in 1978 to only one percent in 1983. Despite the partial grain embargo from January 1980 to April 1981, US-Soviet agricultural trade did not decline nearly as much. Although the Soviets have increasingly diversified their sources of grain supplies, the US, as the largest and most stable exporter of grain, remains an important source for Moscow.

- The USSR continues to be the single largest buyer of grain from the US.
- During the 1984-85 marketing year, Soviet purchases of grain reached a record 22.7 million metric tons.

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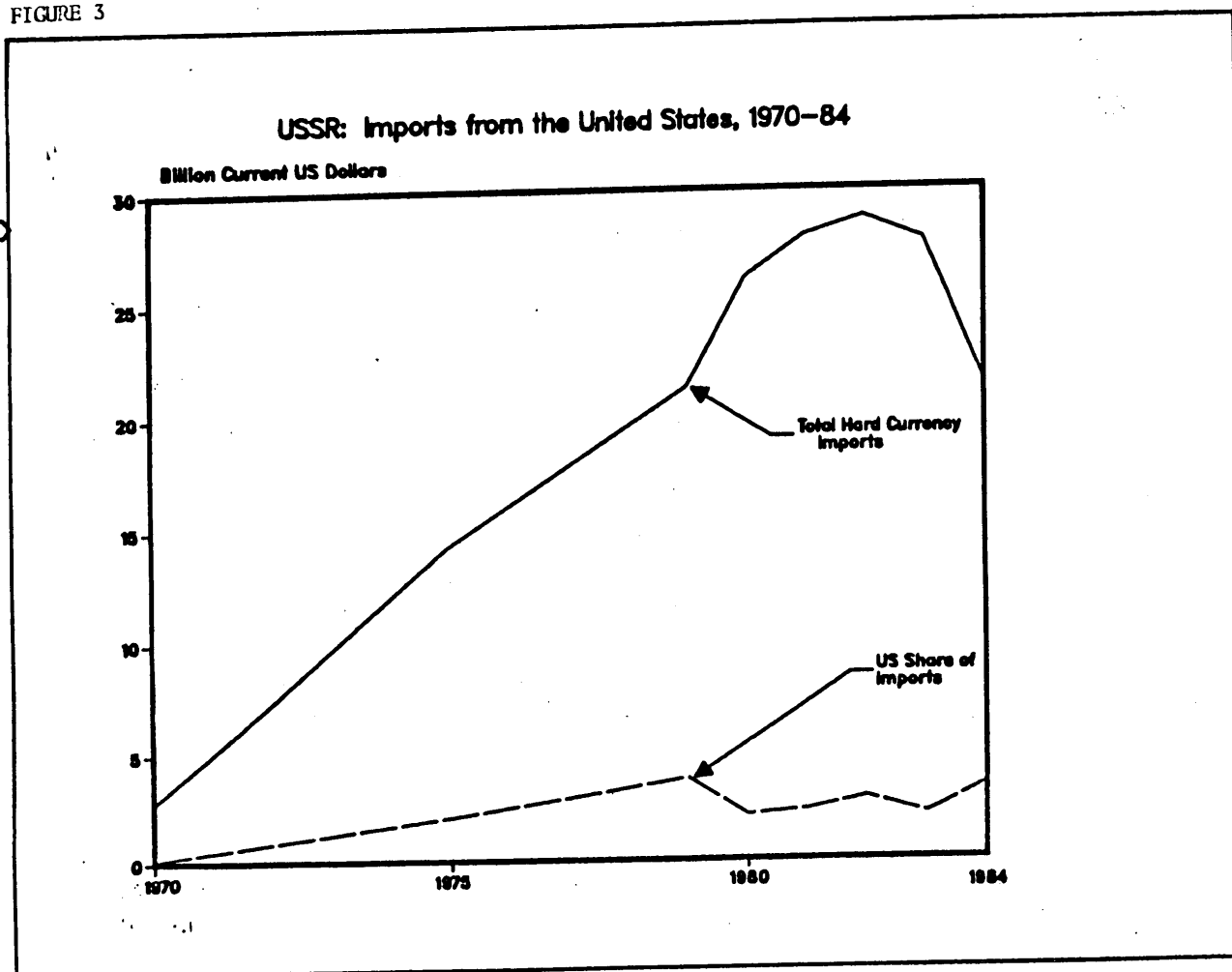
Foreign Trade Under Gorbachev

Since taking over as General Secretary in March, Gorbachev has made it clear that improved economic performance is his top priority. His plan focuses on modernizing the industrial base with more and better machinery--a strategy which could lead to an increased role in both Eastern Europe and the West.

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Gorbachev is undoubtedly hoping for an increase in the flow of machinery from Eastern Europe and has spoken about the need for broader and tighter intergration within CEMA. While such

FIGURE 3



rhetic is not new--the USSR has long advocated joint production and specialization within CEMA as a means of getting the East Europeans to cough-up more--Moscow seems more intent than ever on pressing its allies to make firm commitments on this issue. In this regard,

- An agreement signed by CEMA Prime Ministers in June pledged multilateral cooperation in designing and producing computer controlled systems.
- The agreement follows a recent call in Pravda for a 50-100 percent increase in the rate of growth in machine-building in CEMA countries during 1986-90. [REDACTED]

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Moscow is probably limited in just how much it can get from its allies. Because most East European countries are constrained by their own resource and economic difficulties, any sharp increase in machinery exports to the USSR would have to come at the expense of much needed domestic investment or sales to the West that bring in hard currency. Such a shift would risk undermining growth prospects throughout the area which could cause serious political problems. [REDACTED]

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The limited prospects for sharply boosting imports from Eastern Europe increases Moscow's incentive to trade with the West. In particular, Gorbachev probably will look to the West for imports of technology and equipment for selected sectors--energy and electronics, for example--where no good supply alternatives exist. Moreover, Moscow is presently in a good financial position to increase its purchases of Western machinery

and equipment--at least in the near-term.

- With a relatively small debt and approximately \$10 billion in assets in Western banks at yearend 1984, Moscow can easily obtain commercial credits to finance new purchases.
- Most West European countries are also offering generous terms on government-backed credits in an effort to balance trade with the Soviets and spur their own economies.

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Over the longer term, however, Moscow's financial position is much less certain--falling world prices for oil and declining domestic production could limit Soviet hard currency earning capacity.

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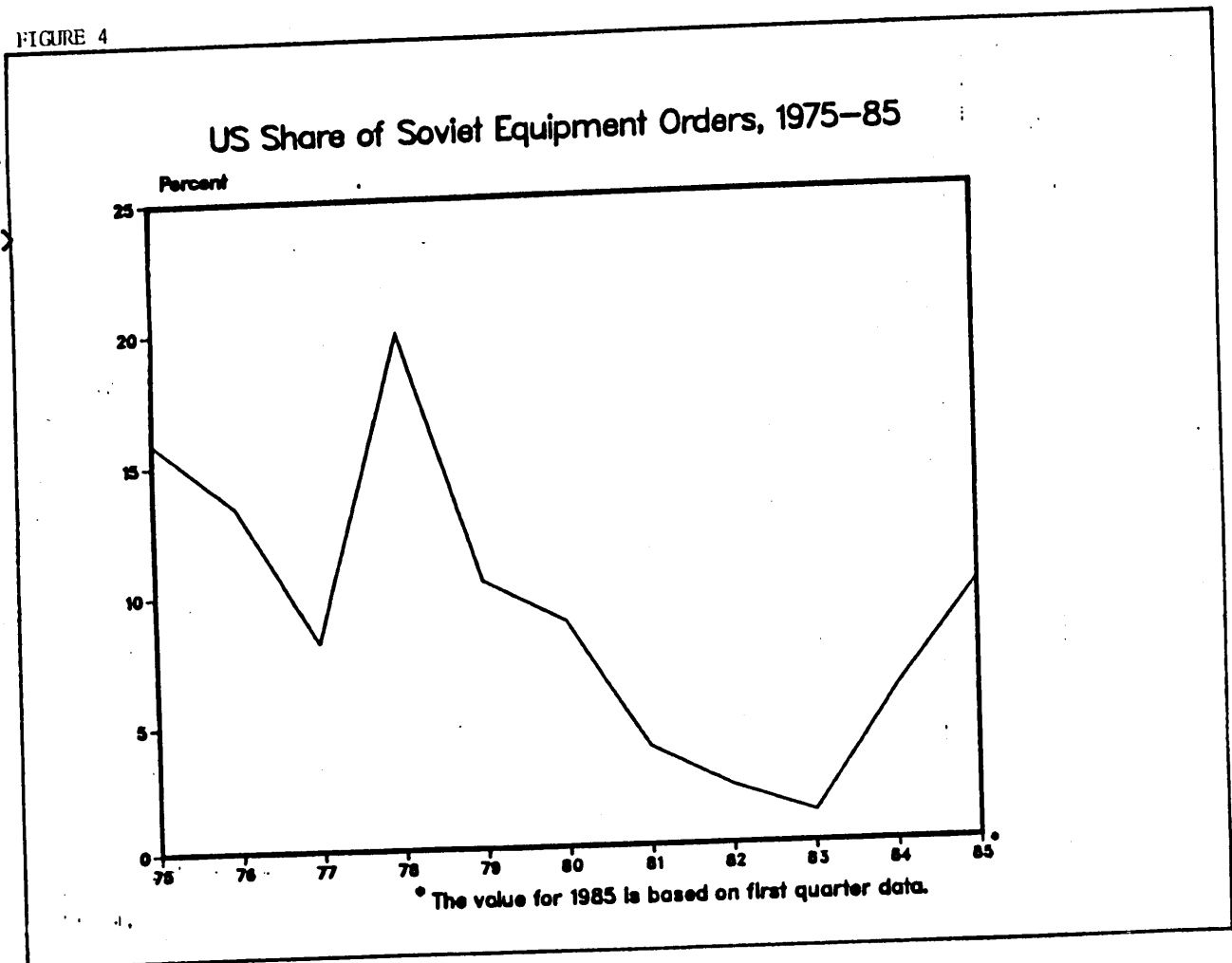
Looking to the US Prospects for an expansion of Soviet purchases of US machinery and equipment appear good--albeit from the extremely low levels of recent years. The share of machinery and equipment orders going to the US during first quarter 1985--10 percent--is substantially above last years 6 percent figure and, if maintained, would be the highest since 1979. (See figure 4) Moreover, the US-Soviet Joint Commerical Commission talks in May 1985 produced a Soviet pledge to

- Try to do more business with US firms.
- Put interested US firms on bidders lists.
- Fully consider US proposals on their economic merit.

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In this regard, we have seen an improved tenor in US-Soviet contract negotiations since the beginning of the year. The

FIGURE 4



[REDACTED]

Soviets are currently discussing major deals with US firms for the sale of personal computers, energy equipment, and agricultural technology. Although these negotiations may be protracted, some signings appear likely. [REDACTED]

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- Nevertheless, the vast majority of Soviet purchases from the US will continue to be agricultural products. Under the current long-term US-Soviet grain agreement (which expires in 1988), Moscow is committed to purchase a minimum of 8-9 million tons of grain per year, with a value of roughly \$1 billion at current world prices. In poor crop years, Soviet purchases can be expected to be much larger. [REDACTED]

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